The Economist
LONDRA

Italy's doom loop

Double act

MILAN

Banks are more exposed to public debt, but also better shielded from losses

IN ITALY'S BUDGET drama, the action is shifting away from Rome. Last month its populist government said it would run a fiscal deficit of 2.4% of GDP in 2019—wider than euro-zone rules permit, and than markets had expected. Cue a sharp rise in borrowing costs, to more than three percentage points above those in Germany (see chart). On October 15th it submitted its plans to the European Commission. With Brussels likely to raise objections to the budget, this spread could rise further still.

Fears about the sustainability of Italy's huge public-debt burden have also infected its financial sector. Lenders' share prices have fallen by 14% since the government unveiled its plans. Compared with Germany or Spain, a relatively low share of public debt—a third—is held by flighty foreigners. But that leaves the financial sector more exposed. So far banks' improved liquidity and capital positions have cushioned the impact of sovereign-debt woes. But not all lenders are well-placed to cope with a further rise in bond yields.

Doom loops, where weak governments and banks drag each other down, featured in debt crises in Greece, Ireland, Spain and Portugal. Euro-zone rules have since restricted governments' ability to bail out banks. Even so, channels connect the two. Banks have big holdings of sovereign debt. And lenders and sovereigns are linked through the economy. If banks deal with losses on sovereign exposures by lending less to companies or individuals, that weakens public finances, closing the loop.

Italy's banks have loaded up on public debt since 2011, in part because such debt is treated relatively favourably by regulators. Their holdings amount to around €390bn ($450bn), or a tenth of their assets, well above the euro-area average of 4%. (Other financial firms, such as pension funds and insurers, hold even more government debt; thanks to quantitative easing, the central bank owns a chunk, too.) Rising sovereign yields directly affect banks' financial health by making funding more expensive, and losses harder to withstand.

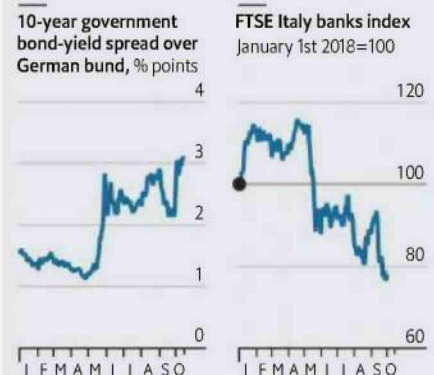
Tapping funding markets has already become more costly. Francesco Castelli of Banor Capital, an asset-management firm, notes that large banks were issuing four-year bonds at interest rates below 1% in May; rates have since crept up to nearly 2.5%. Smaller banks, he thinks, could face forbiddingly high rates. Fortunately, banks are "awash with liquidity", says Guido Tabellini of Bocconi University. Their holdings of liquid assets, as a share of their short-term obligations, are above regulatory floors. And they have been heavy users of the European Central Bank's targeted longer-term refinancing operations (TLTROS), which offer cheap funding.

But the pain of higher funding costs may merely have been deferred. Banks must begin repaying the €250bn they have borrowed through the ECB's scheme from mid-2020. They may need to start refinancing earlier, says Mr Castelli: TLTRO funds will stop counting towards some regulatory measures of liquidity once their maturity falls below a year. If funding costs are still high when banks need to raise money, their profitability will be squeezed, unless they can pass the increase on to customers.

Sustained rises in sovereign-debt yields (and thus falling bond prices) also mean that banks have to reprice their holdings of government debt. That will erode capital buffers—their ability to withstand future losses. Bank analysts reckon that increases in spreads seen so far have had small, manageable effects on banks' capital ratios.

Further large rises in sovereign spreads, though, could spell trouble. Analysts from Credit Suisse, an investment bank, reckon that some banks would need fresh capital once spreads pass four percentage points. Mid-sized banks such as Monte dei Paschi di Siena, which has had a string of troubles, and UBI Banca and Banco BPM, look vulnerable. They are more exposed to public debt, and have lower capital ratios.

The larger lenders, Intesa Sanpaolo and UniCredit, have done more to shore up profitability by cutting costs and selling non-performing loans. But much higher government borrowing costs would bring down the curtain on economic growth. Non-performing loans would start to rise again, threatening profits. No one is predicting a recession in Italy just yet. But the theatrics are not over. ■



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